# Establishing a Credit Rating System for Local Governments



**ALTERNATIVE FINANCE** 

Notes 1

**Policy Support** 



The presence of many independent rating companies will facilitate for institutional and individual investors--the users of credit rating--the identification of local governments which are credit worthy.

### Prospects for LGU Credit Rating

Demand for an independent credit rating of a local government unit (LGU) or its bond issuance is directly proportional to the growth and acceptance of LGUs as capital market players. The development of the municipal bond market is, however, largely dependent on strong government support through legislation and executive action especially through tax incentives and improvements in LGU operating and financial processes.

Today, we are beginning to see some national government attention and private sector support given to municipal bond market development. The work, however, could take years, and quite a lot of advocacy is required to gain acceptance of the LGU credit rating and its attendant cost especially by the LGUs themselves. The work can be shortened if various bond players and the national and local government get together and agree on certain basics in the municipal bond infrastructure, such as bond rating as a "must."

Three or more independent credit rating agencies competing for the municipal bond rating market could make for a more active credit rating industry. While the presence of many independent rating companies could result to unhealthy practices among rating companies, such as the giving of "friendly" ratings just to get the business, the users of the rating—the institutional and individual investors—would eventually catch on and determine which company is more credible. If the current government's interest to see LGUs become more financially independent and professionally run were sustained, we would see a lively secondary market for municipal bonds, all independently rated, in the medium-term.



## **Technology**

#### The Credit Rating System

Credit rating is a system of determining the tendency and capacity of an individual or company to pay financial obligations to creditors in relation to a set of standards which may have been derived from the performance of an industry or which represent the minimum acceptable requirements of a lender. It is not necessarily a standalone measurement of a ratee's capacity to pay debts, but it is an estimation of the ratee's payment potential compared to others.

A credit rating is a formal evaluation of a borrowers capacity to pay as well as the amount of risk that a financial obligation will not be honored and result to loss on the part of the creditor. The ratee's track record in paying loans, suppliers' credits, and other monetary obligations are reviewed.

Capacity to pay is assessed through the ratee's past and projected financial performance. The ratee's projected financial position should indicate clearly ability to service all current and expected obligations. Major analytical factors in determining capacity to pay include: (1) industry risk, involving a review of the national and local government policy and regulatory environment, market trends, opportunities and impediments, and economic sensitivity; (2) management and corporate strategies, involving credibility, risk tolerance, and managerial vision; and (3) business plans, involving projected demand for the company's products or services, market share. and distribution channels.

Even with a credit rating, there is still a need to do project evaluation for loans intended for a specific project. While credit rating provides lenders a general overview of a borrower's capacity to pay, project evaluation de-

termines the success potential of the project to be financed thus, serves a determinant factor for creditors in deciding to extend credit or not.

Credit rating may be done internally or independently. Most, if not all, financial institutions (FIs) have internal credit evaluation systems which may or may not result to a conclusive credit rating for a potential borrower. At the very least, the FIs will have minimum credit requirements or standards which must be satisfied by the borrower to have his credit application approved. These standards are the FI's credit benchmarks, which may range from acceptable financial ratios, collateral positions, to sufficient down payment or equity.

Some FIs may carry the quantification of standards further by assigning equivalent "scores" for the applicant's performance in each credit benchmark and comparing the total of individual scores with a required minimum credit rating. Usually, the credit rating is a major factor in determining the interest cost. The higher the rating, the lower the interest cost. FIs may impose specific requirements in addition to an overall credit rating.

Internal credit requirements or standards are usually unique to each FI. They are a product of the FI's years of experience in working with certain types of individuals, companies, products, or industries. The standards are often derived from hard data collected by the FI over the years and updated regularly as new data come in. They typically reflect the FI's overall comfort level of potential borrowers' tendency and capacity to pay.

Credit ratings are not made public and generally remain known only to the FI and the loan applicant. Most FIs will be hesitant to make public their "rating" of an individual or entity because their credit evaluation process may be relevant for internal purposes only, or they avoid questions on the reliability of their credit rating system.

There are credit rating agencies that provide independent credit rating services for a fee. These are companies whose primary function is to investigate, analyze, and maintain records on the credit ability of individuals and businesses. They have developed standards for evaluating borrowers in which the resultant credit rating is normally expressed in letters or other symbols, such as triple A/B/C, double A/B/C, single A/B/C or their variations with corresponding equivalent levels of credit risks. The information base of rating agencies from which standards are derived usually consists of statistically determined sample of a population of relevant entities. The standards are not necessarily the requirements of the credit rating agency, but a representation of what is acceptable or prevalent in the industry to which the entity belongs.

Credit rating agencies are said to make more objective ratings because they are disinterested parties in the credit transaction. Credit ratings to be credible should be independent and transparent, while the rating agency must have unquestionable integrity.

Among the debt instruments which are rated independently are commercial papers and bond issues which are traded in the capital market. The rating gives investors an idea of the level of risk or probability of default on repayment of the debt instrument. It helps them decide if the risk level is acceptable, and if the debt instrument is worth buying.



## **Policy and Practice**

#### **Enabling Framework**

Through years of dealing with the LGUs, financial institutions have developed internal LGU credit evaluation methods. DBP treats LGUs as regular corporations and evaluates LGU loan applications as it does private borrowers. Basically, DBP evaluates: project viability and the LGU's absorptive capacity as defined by law—the 20 percent debt cap. For non-revenue projects, DBP rates only the LGUs absorptive capacity. The Internal Revenue Allotment (IRA) and the IRA depository arrangement between the LGU and DBP does not form the basis for loan negotiations thus, DBP considers all LGUs equal in terms of risk level.

The Philippine National Bank (PNB) evaluates LGU loan applicants in much the same way as DBP. PNB emphasizes on ensuring the validity of the project contracts and enforceability of the loan transaction, and so requires that all documents must be in order and all processes that PNB prescribes must be followed by the LGU.

Land Bank of the Philippines (LBP), developed an internal LGU credit rating system which has been in use since 1995. The LBP system considers not only the financial operations of the LGU but also its political stability and peace and order situation, among others. It requires LGU borrowers to go through the rating process and to be accordingly graded as prime, high-grade, and medium-grade according to benchmarks.

#### **Practices That Are Working**

The Philippines has had very little experience in municipal bonds. Much of the past municipal issues were housing bonds backed up by government guarantee but not by credit rating. With the establishment of the LGU Guarantee Corporation (LGUGC), a private guarantee corporation with the Bankers Association of the Philippines (BAP) as majority owner in partnership with the Development Bank of the Philippines (DBP), the market finally saw the flotation of nonhousing, revenue-generating municipal bonds beginning 1999. These were the P25 million bonds of Urdaneta City for the upgrade of its existing abattoir; the Aklan Province P40 million bonds to finance the construction of an all-weather jetty port and port terminal in Caticlan; and the P320 million Puerto Princesa City Green Bonds for the City's social housing project.

A municipal bond is exempt from registration with the Securities and Exchange Commission thus, there is no legal impetus for a municipal bond rating. In the absence of a local rating agency with municipal bond rating experience, the LGUGC designed its own LGU Screening and Rating System in coordination with a local consultant and had it reviewed by foreign experts. This is in anticipation of the institutionalization of the bond rating as a requirement in the eventual development of a secondary market for LGU papers. The first three revenue bonds mentioned above were subjected to the LGUGC rating system, which is in its pilot test run. LGUGC plans to spinoff this function and create a separate company preferably in partnership with other development institutions to ensure the independence of the LGU credit rating activity.

The former Credit Information Bureau, Inc., now Philippine Rating Services Corporation (PhilRatings), has rated commercial papers issued by private corporations since 1985, but has not done any sub-sovereign rating. In 1999, Thomson Ratings Philippines, Inc. was established in the Philippines as a joint venture between Thomson Financial, an international rating agency, and International Finance Corporation. Although the expertise of Thomson Financial is in bank ratings, the joint venture is yet to publish its rating system.



Your link to progress

The LGU Guarantee Corporation (LGUGC) is a joint venture between two respected institutions in the banking industry, the Bankers Association of the Philippines (BAP) and the Development Bank of the Philippines (DBP). LGUGC's business is to guarantee LGU debts obtained via straight loans or bond flotation.



Participating Financial

Local Government

 Provides loans Underwrites bonds

- Guarantees LGU debt
- Pays the financial

- Calls on guarantee
- LGU debt default

All revenue-generating projects are eligible for LGUGC guarantee, among which are: Infrastructure Agri-business and Food Production Public Utilities

> Tourism Promotion Housing Education and Health Industrial Estates

> > LGU Guarantee Corporation

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## **LGU Action Agenda**

#### **Gathering Essential Information for Credit Rating**

LGU credit rating follows the general credit rating process. Tendency and capacity to pay are determined using the local government's past history of debt servicing and financial management capability. However, there are certain risk assessment criteria which are not applicable to LGUs thus, other criteria are added or substituted which apply to the political as well as corporate capacities of LGUs. For example, given the changes in LGU leadership at least every three years and at most every nine years, the weight of the LGU's credit history in the overall rating may vary depending on whether or not the

incumbent had an influence, direct or indirect, on the past performance. The current debt burden of the LGU and its debt structure should nevertheless influence, direct or indirect, on the past performance. The current debt burden of the LGU and its debt structure should nevertheless, provide good information base for evaluating the LGU's capability to pay.

Meanwhile, most financial ratios normally used to determine a company's overall financial management capability would not be applicable to LGUs. Given that the LGUs are not profit-motivated but service oriented, efficiency indicators would be more meaningful than profitability indicators. Performance is assessed through historical information on sources of revenue, tax collection rates, and revenue distribution. Likewise, dependence on specific revenue sources and the percentage contribution of locally derived income are major analytical factors of IGU credit rating.

Another area for rating an LGU is its ability or political discipline to maintain sound budgetry policies and practices, which is done through a review of the LGU's past financial operations, specifically its ability to maintain consistently a balanced budget.

An assessment of the socio-economic environment of the LGU is necessary. Economic factors such as trends in personal incomes, population growth, real estate valuation, and local employment are evaluated to arrive at an overall rating of the LGU's capacity to pay.

For project financing, the underlying principle in credit rating is the ability of the project to generate sufficient cash inflow to pay financial obligations until maturity. Crucial to LGU project loans is ensuring the enforceability of the debt contract by establishing that all requisite government rules and regulations on loan and project contracting are followed.



In credit rating, LGU capacity to pay debts is evaluated through historical information or ability to generate sufficient cash inflow through taxes and other revenues, socioeconomic environment, and ability to maintain consistently a balanced budget.

#### Getting the Benefits of a Formal Credit Rating

The internal credit evaluation or scoring systems of financial institutions may suit their objective to make the decision to lend or not to an LGU. But LGUs which want to access the capital market will need a formal credit rating from an independent and credible rating agency before they can issue commercial instruments such as municipal bonds. Formal credit

ratings are used by private investors and the general public as a basis to determine what LGU debt instruments to buy.

The primary benefit a formal credit rating provides is that it determines the borrowing cost and marketability of the LGU debt paper. Regardless of its size, a municipal bond issuer with a high investment grade can declare

lower yield on its commercial paper compared to an LGU with a lower rating. A high rating signal low risk and attract institutions and private sector to invest in the debt paper thus, providing the LGU its needed capital to undertake infrastructure and other high cost development projects to improve the LGU's services to its constituents.